Marion Williams: Central banking in a global context – promoting both national and regional economic gains

Feature address by Dr Marion Williams, Governor of the Central Bank of Barbados, delivered at the 35th Anniversary Conference of the Central Bank of Barbados, Bridgetown, 10 May 2007.

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Mr. Chairman

Members of the Board

Deputy Governors

Distinguished Panellists

Members of Management and Staff,

Distinguished Ladies and Gentlemen:

I am delighted to welcome you to the Central Bank and to the Frank Collymore Hall. Over the years, the Bank has set itself the goal of promoting dialogue on topics of economic and financial interest. Such an occasion as our 35th anniversary could not therefore pass unless we staged such a dialogue on a topic of economic interest. We are delighted to welcome our panelists Dr Trevor Farrell, formerly of the University of the West Indies at St. Augustine, Dr Gregor Heinrich of the BIS and Dr Jose Blanco of the Latin American Monetary Council. My presentation is intended to set the scene for later discussion by our panelists, some of whom will share with us the integration experience in other jurisdictions.

Given the pace and momentum of global change, Central Banks in developing countries are often unable to influence global forces. However it is important that we adopt our approaches to accommodate to these forces of change.

The timing of the formation of the Caribbean Single Market & Economy (CSME), coming as it does at the turn of the 21st century, is a time when our economies are now more exposed to the opportunities and pressures of economic and financial integration than ever before. The precise implications are continually unfolding, what we know is that the gains for the region have the potential to be significant if our responses are regional rather than national and sooner rather than later.

Let me focus first on a few global economic and financial developments which have implications for Central Banks and for the region before turning to regional issues.

Integration of markets and economic growth

Compared to even a decade ago, world financial and product markets are significantly more integrated. Cross-border flows of real and financial capital have also increased dramatically - a reflection of the notable reduction in the degree of home bias in capital markets. Along with the evolving pattern of cross-border flows, we have also seen profound increases in the absolute size of current account balances in both industrial economies and emerging market economies. A more integrated world economy brings with it the prospect of a more productive, yet competitive world economy. The increase in the ties between national financial systems as well as the greater sophistication of financial markets and financial market instruments allow risks to be shared more broadly and capital to flow to where the returns are expected to be the highest.

The recent spurt in integration has occurred during a sustained period of relatively strong and steady growth on a global scale and of relatively stable and low inflation rates. These improvements in outcomes have surfaced amidst a number of other important changes in the environment, including significant technological progress and better economic policies steady growth in Latin America and the Caribbean and more stable emerging economies particularly in Latin America. But even without being able to assign precise shares to all the contributing factors, we know that greater integration and openness are likely to have been particularly important in the Caribbean case.

China through its Central Bank the National Bank of China has become the repository of vast foreign exchange reserves principally in US Dollars. China is also competing with many of the international lending agencies for the attention of many West African countries, where access to less complicated loans are becoming attractive. Regional economic units are looking to each other and to their central banks for balance of payments support rather than to international institutions. Also private credit markets are now accessible to central banks and to governments in a way which did not obtain in the past.

Economic modeling and monetary policy

All of these developments have impacted on the way in which central banks do business. Many Central Banks in the region are therefore redesigning their policy responses, not only in the context of global forces but in the context of adjusting to the fact of greater regional economic and financial integration.

Our models however are pressed to catch up with the changes. Economic theory is most comfortable with fully integrated systems in which prices and flows of goods and services along with real and financial capital respond continuously and completely to market forces. Significantly harder to capture in our models are those factors that do not fully, or quickly, adjust to market incentives, or where those incentives are hidden. In the dynamic landscape of the 21st Century, economic modeling has therefore become the subject of continuous adjustment as relationships and responses on which these models are based, change more frequently and become less standardized as national and regional flows, policies and economic decisions accommodate to each other.

Yet in the world of risk management instruments it is expectations that are important and margins of error have to be minute in order for financial markets to be efficient and avoid major losses. This is a challenge for developing countries who need to manage risks but have thin financial markets.

At the same time traditional armour of central banking is also subject to continual adjustment. New relations and responses have the potential to alter the incentives of businesses and investors, and change the accustomed rate and direction of flow of goods, services, labour and capital. The lesson here is that in this era of liberalization of capital flows, central banks have to be nimble and quick in their responses, less bound by theory and more by pragmatism in doing what is in the interest of the economy they serve.

The pace of progress is in the direction of more openness to capital flows and the ability to adjust to this openness, will depend in part on the pace at which countries are able to strengthen the resilience of the domestic financial system and set in place the broader institutional framework, including real time information systems and regulatory regimes that are vital for open economies. In this regard, in almost every central bank in the world bank supervision departments are growing and new risk management techniques are being developed.

Higher reserves

Globalization of markets and greater openness has led to the holding of higher levels of foreign exchange reserves by most countries across the globe. Indeed as cross-border transactions grow there is a worldwide trend towards higher levels of official reserves in most emerging markets. This is not simply the consequence of a desire for a greater financial cushion against external vulnerability, but reflects the increasing level of interaction of national economies with the regional and global economies. In addition many central banks are increasingly diversifying the currencies of their foreign reserves holdings.

Collective responses

Another global trend among regional groupings is a trend towards the establishment of regional foreign exchange pools. The 1997 the financial crisis in East Asia was a wake-up call to governments of developing countries that financial markets and institutions must be sufficiently prepared to manage globalised capital flows, before there was full market liberalisation. Specifically, in South East Asia, financial institutions had to be reformed and restructured, capital markets broadened and deepened, and supervision and regulatory standards upgraded. Most importantly the regional response that followed encouraged governments to consider establishing regional financial facilities in that region. As a result, the Chang Mai initiative by South East Asian countries was established as a buffer which offered greater and quick foreign exchange access. Today, a collective response drawing on that regional integration initiative would be possible as apposed to the individual country responses witnessed in 1997. This example of repositioning of South East Asia is of significant import for Central Banks in other regional arrangements and other regional groupings are considering the establishment of such pools.

At the same time, globalization and the reliance on the market and the decline in discretionary monetary policy has limited the policy tools of central banks. Domestic monetary policies of national central banks now face the money flows from international sources which have the potential for making domestic policy less effective. At the same time the wide disparity in interest rates and inflation rates across the globe is narrowing.

Inflation and monetary policy

While central banks in this region have multiple goals of ensuring financial stability, executing monetary policy and helping to develop a stable economic and financial environments, price changes and inflation control have not been a major issue as it has been seen in Latin America in the 1970s and 1980s. Also, in the developed world inflation targeting is an important objective of Central Banks. Indeed, noted economist Ken Rogoff and others have pointed out that to the extent that globalisation increases the degree of competition, it can reduce the "inflationary bias" or, to put it differently, it can strengthen the anti-inflation credibility of a central bank. By promoting greater price flexibility, competition lowers gains in the short-run to output from an unanticipated inflation. The improved credibility of the central bank's commitment to keep inflation low and stable should, in turn, allow it to deliver better inflation outcomes with fewer short-run costs to what many may consider as political objectives of economic growth and employment.

It is however often not quite clear whether the successful control of inflation has been a result of inflation targeting policies or of competition from South East Asia, China and India and other developing countries which has driven prices down.

However, in the Caribbean inflation targeting has not been the major goal of monetary policy up to now, but rather a subsidiary goal. And this has been largely because much of our inflation has been imported. However, high oil prices, the more rapid growth of regional economies in recent years, coupled with expansionary fiscal policies and demand pressures of expansion of some regional economies, has brought the spectre of inflation more to the fore. This has been so more in the rapidly growing economies elsewhere in the Caribbean, but countries like ourselves have not been exempt. While the monetary policy levers for control of inflation may be limited, the fact is, inflation control is likely to become a more central part of both policy making than before if oil prices remain high. This however may have less to do with regional Central Banks adopting inflation targeting as a goal and more with the goal of ensuring that monetary and other policies do not contribute to the imported component of inflation over which we are aware is beyond our control, if we adopt counterbalancing monetary and fiscal policies. Here the trade-off is usually to sacrifice some growth for lower inflation. This is not a win- win situation.

As economies become more integrated, external factors can have a stronger impact on the movements of some prices. Rapid demand growth, commodity price volatility, and the influence of a broad range of global and regional conditions on wages can all trigger large changes in relative prices. So central bankers have to be careful not to focus too narrowly on one particular measure, or indeed in our context to allow it to be thought that the Central Bank can control inflation. Having said that, some central banks in developing markets of Latin America have adopted inflation targeting. There may however be measures which can be taken in terms of controlling money creation which can help to dampen inflation. However the levers for control do not all rest with central banks.

Interest rates were always important but external interest rates are becoming more important in the design of monetary policy by central banks. If the prevailing patterns of capital flows were to exert downward pressure on interest rates and upward pressure on other asset prices, they would contribute to more expansionary financial conditions than would otherwise be the case. When this happens, it can mask the effect of other forces that might otherwise have exhibited themselves in risk premia or higher interest rates.

As the conduct of monetary policy becomes more challenging it also obliges policymakers to devote more care to the process of understanding how the changes at the global level affect the balance between opportunity, risk and uncertainty, so that we have the flexibility to respond efficiently and in a timely manner to any crisis to the extent that domestic policies will allow.

Transmission mechanism

Also, our understanding of the transmission mechanism of monetary policy, with respect to cross border markets will become increasingly important in the globalized world Already, the BIS is tracking global flows and probably has access to more comprehensive data on cross border financial flows in the Caribbean than we do on the region with respect to our regional neighbour’s data.

Regional

I will now turn to the regional focus. In the Caribbean context, the efficacy of monetary policy can be reduced as a result of long lags and the inability to control the money supply directly. As a result, monetary policy has often played a largely supportive role to fiscal policy. However, a single market and the opening of capital accounts will reduce the effectiveness of traditional monetary policy prior to implementation of a single currency and while market instruments will help to influence outcomes they will tend to operate at the margin and will tend to be more effective in tight liquidity situations and costly for the central bank in excess liquidity situations, as a couple of our neighbours can attest.

A common currency

Key among the policy choices for monetary implementation in the region will be a common currency. The proposal for a single economic space for the Caribbean region is not new. It has been suggested from time to time over the last few decades in one form or another, as part of promoting regional economic cooperation.

A common currency represents the ultimate in the economic integration of states and is normally the product of a currency union. It is a zone of countries or a region, where a single currency circulates, a single monetary authority or central bank operates, a single exchange rate policy prevails and the single monetary authority often maintains a common pool of reserves. The literature identifies the following as key deciding factors for a currency union: openness, high intra-union trade, a high degree of product diversification, similarity in industrial structures, high correlation in economic activities, similar inflation rates, flexibility in wages and prices and factor mobility.

There are many compelling reasons in favour of a common Caribbean currency. Currently, the overwhelming majority of regional trade is conducted using the US dollar which fetches vastly different values against the various regional currencies, whether fixed or floating. If we do nothing the numeraire currency will be the US Dollar – by default. A single currency for the region would lead to elimination of transaction costs and of volatility in exchange rates among members of the regional grouping.

Just as a common language promotes communication among people, a common currency could promote trade and investment among countries in the region. These benefits will have to be weighed against the likely costs that have to be incurred by the region. These would involve the costs of discontinuing their own independent currencies by replacing with the common currency, and the loss of seigniorage revenue from printing their own currencies.

The gains from a currency union, which are in terms of increased efficiency, arise primarily from two sources. The first is that a common currency eliminates transaction costs usually incurred when trade and investment transactions need currency conversion. Secondly, a common currency eliminates risk from the uncertainty associated with the differences in exchange rates between trading partners. One more gain is that a currency union provides a potential for reinforcing fiscal discipline and credibility of monetary policy.

There are also disadvantages to a common currency. They relate to the loss of two important macroeconomic adjustment tools, namely independent monetary and exchange rate policies. The member country has to abide by common monetary policy for the union as a whole; and it has to relinquish its exchange rate, an instrument for protecting itself from economic shocks. However, the costs are less severe if the shocks affect all member countries in the union in a similar fashion, and a common monetary and exchange rate policy vis-à-vis with the rest of the world would then be appropriate. In such a scenario the national gains would be positive for all.

On the other hand if the shocks were asymmetric in nature, affecting the countries in a dissimilar manner, due to reasons such as different industrial structures, a common policy would be less desirable. However, disadvantages of such a nature can be reduced to a great extent if prices and wages are flexible and if there is perfect labour mobility between member countries. Thus, downward flexibility of wages and prices and labour mobility will enable the member countries in a currency union to withstand shocks of asymmetrical nature.

The important issue here is what the operation of a common currency would imply for the conduct of monetary policy in the CSME. A common currency necessitates a single set of economic, monetary, financial and fiscal policies which would ensure balance of payments viability for the region. Accordingly, all of the countries in the union would have to fall in line with the currency's monetary and exchange rate dictates. No agreement has been reached on whether the common currency would be fixed of floating. Also, there would need to be harmonized fiscal policies to ensure the success of regional monetary policy.

Such a single set of policies has better likelihood of success when there is a high degree of synchronization of business cycles for all prospective member countries of a currency union. According to optimum conditions, countries experiencing common external shocks would be better suited to form a currency union because it permits the use of region-wide policies to correct any imbalances. The reality in the Caribbean is that some of these second order conditions do not hold in all respects. For example, while Trinidad and Tobago is a major producer of petroleum, most of its CSME partners are oil importers. Regional monetary policy would have to be fashioned very cleverly and with the utmost sensitivity in order to be generally applicable to all the countries in order that gains may be shared both at the national and regional level.

However, a currency union it is argued, could help make the shocks affecting member countries more symmetric in the future and might also expand intra-regional trade. These arguments are not different from the observations made by theorists, when the European Common Market was born. It was felt that common currency arrangements would by themselves reduce dissimilarities among member countries. However, it should be noted that the EU member countries did not plunge into a currency union arrangement, as they were aware of the pitfalls and insisted on fulfilling the convergence criteria contained in the Maastricht Treaty of 1991 and the requirements under the Growth and Stability Pact of 1996.

A common currency offers an easy way to economize on the use of foreign exchange since all regional transactions would become domestic transactions and would not require foreign exchange. This is the single most important area in which regional gains and national gains coincide, and an area in which all can benefit.

Preliminary economic convergence

Convergence criteria which have been established as conditions for entry to the Caribbean Monetary Union are currently often breached without sanction. It is interesting to note that in an article by Alexandre Lamfulussy, it is claimed that in Europe, among the convergence criteria for accession to EMU, the fiscal ones and the inflation criteria were of critical importance in the ultimate success of the European integration efforts. The members of EU were also required to open their capital and labour markets by implementing policies towards harmonisation of a wide range of commercial and legal standards. Ancillary issues including labour mobility and fiscal transfers have far reaching implications and often need their own policy focus.

Monetary union apart, the full implementation of the CSME will bring to the fore a number of issues which will require harmonization of macroeconomic policies in the region prior to the establishment of a single currency.

In the present economic system, regional integration can at times be a naturally-occurring phenomenon. Natural market integration is a process characterised by progressive convergence of economic and social parameters among countries which exhibit increasing degrees of interdependence. However, in the early years of CARICOM the Caribbean was mostly policy induced, in later years, co-integration has been occurring more naturally with greater movement of people and capital. This formal policy co-operation which began in 1973 with the Treaty of Chagauramas to be followed in 1989 with the Grand Anse Declaration, set out the roadmap for the formal push towards the CSME.

There is a particularly extensive post-World War II experience of economic integration. We have seen that the most typical starting point of economic integration has been the creation of free trade areas, often with the objective of deepening into a common market or community. In these respects, with the formation of the CSME, our regional direction is no different from that of other groups. Financial and monetary cooperation tend to be the last bastion as we have seen with the euro and the European Central Bank.

Structural reforms and global participation

While central banks in the region will need to be more closely involved in monetary policy coordination, the broader need will be to strengthen structural reforms and to enhance the capacity to participate in the globalisation process. This can be seen by examining some of the key objectives of the new regional integration movement, namely export growth and diversification, institutional modernisation, functional regional cooperation, economic transformation, the promotion of foreign direct investment, and trade liberalisation.

Private sector participation

We have already seen that joint ventures and pan-Caribbean companies have been expanding briskly in the region and have been using the region as a platform for launching into the wider global environment. Such ventures build on the comparative endowment of regional countries, promote cooperation in joint production by matching countries that have natural resource endowments with those that have financial capital or other inputs. The private sector should assume the lead role in developing these business arrangements. Indeed, the number and frequency of amalgamations, mergers and acquisitions across the region continues to grow. However, a study on home –bias in Europe, by Kho, Stulz and Warnock point to a preference for investing at home. This is likely also to be the case in the Caribbean. They noted that investors are more optimistic about their home equity markets than about foreign markets – even with free movement of capital. This means that interest rate differentials need not fully reflect the competitive level needed to keep capital at home.

Growing and mutually beneficial economic interdependence among partners typically induces demands for additional regional economic co-operation to exploit more fully the advantages of a maturing regional market. Success is therefore likely to lead to further success. There may even be some critical point that needs to be reached before take-off. In the same manner regional gains will become national gains once this point is reached.

Non-economic cooperation

In effect the same forces of trade among partners can be the effective drive towards deeper formal integration whether they were planned or not. In short, many countries that have entered into a trade-based integration framework have found that it involves highly complex, policy-induced financial integration which, as a result usually lags the integration of goods markets. In this case the financial integration entails the liberalisation and harmonisation of money and capital markets to facilitate payments and investments, and this provides a primary source for medium to long-term securities and debt instruments, which are essential for investments in the regional market. The process includes all capital markets' institutions, such as commercial banks, private financial institutions, investment funds, insurance companies and of course, central banks. That is, the process usually involves the business development first and capital markets after. We have already been moving in this direction, as is evidenced with the planned introduction of the Caribbean Exchange Network which is the collaboration of the three stock exchanges of Barbados, Jamaica and Trinidad & Tobago. That is with growing direct investment capital market development is likely to follow. However, though the structures are being put in place to facilitate greater movement of capital cross borders- where foreign exchange risks still exits, there may not be a massive movement of funds until the single currency is in place. Such an event would then lead to a faster elimination of interest rate differentials in the region and hence lower transactions cost.

Regional financial integration

With the drive towards a Caribbean Single Market and Economy, central banks can enhance regional financial cooperation in other ways. One is through the development of real time data sources on liquidity and interest rate movements shared with the region on a daily basis. Notwithstanding the progress made, more can definitely be done to bring regional financial cooperation to a level that is on par with the region's economic and financial potential.

Financial cooperation and efficiency

Financial market efficiency is important in accelerating economic development, and market efficiency also contributes to achieving and preserving macroeconomic stability. In addition to pursuing sound economic and financial policies, the region may need to consider implementing its own financial sector model. Such an arrangement will help ensure an orderly and stable financial environment such that any emerging vulnerabilities may be spotted early and may not pose serious risks to the region's financial markets and economies. Unfortunately the more highly developed the capital market the more rapidly money is able to move and the more volatility exists in the economy. For that reason at least one central bank in Latin America – Chile – placed reserve requirements on inward investments.

Stabilization Fund

Central Banks in the region have a history of financial cooperation going back to the 1970s, when the Central Bank of Barbados made short term loans available to Jamaica and later when Trinidad and Tobago made loans available to the Central Bank of Barbados. Also, twenty-five years ago there was discussion of a regional Stabilization Fund to provide balance of payments support. Three years ago, it surfaced again. On neither occasion did it materialize. Yet a financing facility that draws on the region's own financial strength and resources can be very important. With such a facility in place, there should be greater confidence amongst policy makers and short term stabilization support could be accessed without the major conditionalities associated with conventional international institutions – and that such borrowing could be without strings provided such needs are not structural. Regional financial cooperation should move progressively forward, with the process being further strengthened and should work toward becoming more focused on this important area.

The Regional Stabilization Fund was conceptualized as a short-term financing facility to assist member countries in managing their balance of payments shortfalls at a time of financial distress. Such distress funds should continue to remain a key pillar of regional financial cooperation. This is because it is important for the region to have its own liquidity arrangement that can be called upon when the need arises. I mentioned earlier the Chang Mai initiative in South East Asia.

It is important to note that the BIS had been doing this for European Central Banks since the middle of the 20th century and that even now the European Central Bank does the same by way of swap facilities for North American and European banks. Beth Simmons in an article in a BIS working paper of February 2006 foresees that this kind of support will become more available in Europe. If this is so in Europe how much more so should the Caribbean continue to pursue this initiative.

A Caribbean community

In recent years – just 8 years after its introduction – the euro has strengthened considerably and is increasingly being held as a reserve currency by many central banks.

It is my firm belief that in the same way that trade drove the closer integration of Caribbean economies during the 1970s and 1980s, financial cooperation and cross border flows will be the catalysts for the foreseeable future. Like Europe, financial and monetary cooperation will be the last bastion. Central banking in the region has a role to play in the new dispensation but it must adapt itself to these new paradigms during the adjustment period since continuing stability will be important in the new more liberalized environment. In due course and with careful staging, regional gains and national gains should coincide.

Ladies and gentlemen, I thank you.